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IN THE

Supreme Court of the United States

OCTOBER TERM, 1948

No. 409

HENRY C. RIELY and ROBERT T. BARTON, JR., as Receivers of PIERCE OIL CORPORATION, a Virginia Corporation, heretofore dissolved,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT AND SUPPORTING BRIEF

EUGENE UNTERMYER,
ROBERT T. BARTON, JR.,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Henry C. Riely and Robert T. Barton, Jr., as Receivers of Pierce Oil Corporation, a Virginia Corporation heretofore dissolved, pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit (Rec. p. 26), reversing the judgment of the United States District Court for the Eastern District of Virginia (Rec. pp. 15 et seq.). Such reversal has the effect of dismissing the plaintiffs' claim for refund of undistributed profits taxes under the Federal Revenue Act of 1936, as amended by Section 501(a) of the Revenue Act of 1942.

Opinions Below

The opinion by Circuit Judge Dobie of the then United States Circuit Court of Appeals for the Fourth Circuit (now the United States Court of Appeals for the Fourth Circuit and hereinafter sometimes called the Court of Appeals) appears at pp. 20 et seq. of the Record and is reported *sub nom. United States* v. *Riely et al.*, 169 Fed. (2d) 512. District Judges Webb and Watkins concurred. The opinion of the District Court is not officially reported, but will also be found in the Record at pp. 7 et seq.

Jurisdiction

The judgment of the Court of Appeals was entered on August 17, 1948 (Rec. p. 26). The jurisdiction of this Court is invoked under Section 1254(1) contained in Chapter 81 of the United States Judical Code, as revised, which took effect September 1, 1948, being Chapter 646 of Public Law 773 of the Eightieth Congress, Second Session, enacted June 25, 1948.

Statutes Involved

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

* * * * * * *

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to application of the specific credit as provided in subsection (c):

* * * * * * *

SEC. 26. CREDITS OF CORPORATIONS:

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) [As amended by Section 501(a)(2) of the Revenue Act of 1942, c. 619, 56 Stat. 798.]

Restrictions on Payment of Dividends—

* * * * * * *

(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

Virginia Code of 1936, Section 3840, as it has read without change since 1932:

Capital defined; dividends; liability of directors for declaration of dividends.—The board of directors of every corporation shall, unless otherwise provided in its charter, certificate of incorporation or articles of association, or in any amendment thereto, have power to declare and pay dividends upon the shares of its capital stock *out of net earnings, or out of its net assets in excess of its capital as hereinafter defined.* The capital of a corporation shall be the sum of the consideration received by the corporation in payment for its shares of stock, whether with or without nominal or par value, plus such amounts as from time to time by resolution of the board of directors may be transferred to capital and/or less such amounts as may be transferred from capital by a reduction thereof, pursuant to the provisions of section thirty-seven hundred and eighty-one, and shall not include contributed surplus when, under the terms and conditions of the subscription agreement to any

shares of stock, it is provided that in addition to the consideration paid for such stock, there shall be paid by the subscriber a sum to be contributed surplus of the corporation. No dividend shall be paid, in whole or in part, from contributed surplus upon any shares of stock without written notice being given to stockholders receiving the same, at the time of payment of any such dividend.

If the board of directors declare and pay a dividend *out of any part of the capital*, as hereinbefore defined, all members of the board who shall be present and know that such dividend is declared in violation of this section, and shall not dissent therefrom, shall, in their individual capacity, be jointly and severally liable to the corporation's creditors for the amount of such dividend so *unlawfully* paid and may be proceeded against therefor on a bill in equity filed on behalf of such creditors and, moreover, each stockholder who participates in such dividend shall be liable to such creditors to the extent of such dividend *unlawfully* paid so received by him. (Italics ours.)

Question Presented

Was the taxpayer, a deficit corporation, which had net income for 1937 of $86,412.46, entitled to a deficit credit for purposes of the surtax on undistributed profits under Section 26(c)(3) of the Revenue Act of 1936, as amended by Section 501(a)(2) of the Revenue Act of 1942, because the laws of Virginia prohibited the petitioner from declaring and paying dividends during the year on account of a conceded profit and loss deficit of over $1,000,000 and a corresponding impairment of its capital? The Court of Appeals decided that the deficit credit was inadmissible because the taxpayer could lawfully have paid a dividend to the extent of current earnings for any year, in the face of the continuing capital impairment.

Statement

The case was tried before the District Court without a jury. The facts were entirely stipulated, and the District Court found them to be substantially as follows (Rec. pp. 10-14):

Pierce Oil Corporation (herein sometimes called "taxpayer") was a corporation organized on June 21, 1913, under the laws of the State of Virginia, and by decree of the Circuit Court of the City of Richmond, Virginia, entered December 27, 1940, it was dissolved.

In April, 1940, Henry C. Riely and Robert T. Barton, Jr., were appointed receivers of the taxpayer by order of the Circuit Court of the City of Richmond under the provisions of Section 3813 of the Virginia Code and among other matters were authorized to collect all outstanding accounts and to institute and prosecute within the Commonwealth of Virginia all such actions, proceedings or suits as in their judgment might be necessary for the recovery or proper protection of the taxpayer's property. Henry C. Riely resigned as one of the receivers of the taxpayer on May 4, 1945, and Robert T. Barton, Jr., by decree of the court was continued as sole receiver of the taxpayer.

In March, 1938, the taxpayer filed its federal income tax return for the taxable year 1937 with James J. Hoey, Collector of Internal Revenue for the Second New York District, and paid under protest in four equal installments the undistributed profits tax shown to be due thereon in the total amount of $17,714.55. Collector Hoey, to whom the sums were paid, went out of office on November 10, 1941, and is now no longer living.

For a number of years preceding the taxable year 1937, the taxpayer's operations had been unsuccessful and it had sustained a deficit in accumulated earnings and profits up to and including December 31, 1936, which was the close of its preceding taxable year, and as of January 1, 1937,

which was the beginning of its 1937 taxable year, of at least $1,149,642.76.

The taxpayer had net earnings and profits for the year 1937 (some three years prior to its dissolution and the appointment of receivers) of $86,412.46, no part of which were distributed during the year 1937, but at the close of the taxable year 1936 and during its entire taxable year 1937 it had a deficit in accumulated earnings and profits, and the taxpayer's capital was impaired on December 31, 1936, by at least $1,149,642.76, and on December 31, 1937, by at least $1,000,000.

On or about January 13, 1943, the receivers filed with the Collector of Internal Revenue a claim for refund of $17,714.55 paid as undistributed profits tax for 1937. The Commissioner of Internal Revenue has never taken any action in respect to the claim. More than six months having passed since the filing of the claim, this suit was filed to recover the amount set forth in the claim for refund. The judgment of $17,714.56 and interest entered for the petitioners by the United States District Court for the Eastern District of Virginia (Rec. p. 16) was reversed on the appeal of the United States by the Circuit Court of Appeals for the Fourth Circuit, now the United States Court of Appeals for the Fourth Circuit (Rec. p. 26).

Reasons for Granting the Writ Herein Applied For

I. The Court of Appeals has rendered this decision in conflict with the decision of another Circuit Court of Appeals on the same matter in *Glenn* v. *Mengel Co.* (1944) decided by the Sixth Circuit in 145 Fed. (2d) 235, and affirming *Mengel Co.* v. *Glenn*, D. C., W. D. Kentucky (1943), 50 Fed. Supp. 765. The Tax Court, in *Senior Investment Corporation* (1943), 2 T. C. 140, a case which was at no time appealed by either party, also decided the same question in conflict with the decision herein.

Other recent decisions in the Circuit Court of Appeals that pronounced the same general thesis for which we contend are *Van Norman Co.* v. *Welch* (1944) decided by the First Circuit in 1944, 141 Fed. (2d) 99; *United States* v. *Byron Sash & Door Company,* decided by the Sixth Circuit in 1945 (150 Fed. [2d] 44), and *International Ticket Scale Corporation* v. *United States,* decided by the Second Circuit on January 7, 1948 (165 Fed. [2d] 358).

II. The Court of Appeals has decided an important question of the local law of Virginia involving the lawful right to declare and pay dividends in the face of a corporate deficit and consequent impairment of capital, probably in conflict with applicable local decisions.

III. The Court of Appeals has decided an important question of Federal law arising under the Undistributed Profits Tax Act, as amended by a section of the 1942 Revenue Act that was enacted for the relief of taxpayers, which has not been, but should be, settled by this Court.

IV. The Court of Appeals has decided a Federal question involving the foregoing sections of the Internal Revenue Code, and other important questions relative to the right of a corporation to declare and pay dividends in the face of a profit and loss deficit and consequent capital impairment, in a way probably in conflict with applicable decisions of this Court.

V. The Court of Appeals has so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision, in that said Court has disregarded the applicable authorities that should have governed its decision and relied upon authorities that have no bearing on the situation or that did in fact support the contentions of this petitioner.

In connection with the reasons presented for granting the writ and in support of the assignments of error in the Court of Appeals hereby urged, we respectfully submit as follows:

I

The conflict in the Circuit Courts of Appeals that appears from *Glenn* v. *Mengel Co., supra,* where the Federal Undistributed Profits Tax was also in issue, has arisen under the New Jersey statute that has the same disjunctive phraseology as the Virginia statute, except that the word "profits" is used instead of "earnings". From the standpoint of basic corporation law there would appear to be no reason for drawing any distinction between the use of such words in deciding the question involved herein. The three remaining cases in the Circuit Courts of Appeals previously referred to, also construed the Federal Undistributed Profits Tax, and enunciate the same general rule for which we contend where a profit and loss deficit and consequent impairment of capital prevails. These four cases will be more fully discussed in the attached brief.

The Tax Court decision of *Senior Investment Corporation, supra,* involved a Michigan statute in substantially identical form to that in force in Virginia empowering, as it did, the directors of a corporation to "declare and pay dividends upon the shares of its capital stock either from earned surplus or from net earnings". Since this decision was not appealed, it stands as a recent and undisturbed expression of law by the tribunal particularly entrusted with the interpretation of Federal tax laws. Although the decision is not one of a Circuit Court of Appeals, the existence of this additional conflict should be another persuasive reason for this Court's exercising its discretion to resolve the point.

II

The Court of Appeals has sought to decide an important question of local law in a way probably in conflict with applicable local decisions. In support of its decision, said Court cites without comment *Drewry-Hughes Co.* v. *Throckmorton,* 120 Va. 859, which has no application to the situation presented by this record. The Court of Appeals failed, also, to refer to *Johnson* v. *Johnson & Briggs,* also decided by the highest Court of Virginia in 1924 (138 Va. 487), wherein the views of that Court appear at variance with the conclusions arrived at by the Court of Appeals, as will appear from the appended brief. The decision is contrary to the general understanding of the Virginia Bar regarding the meaning of the statute, as appears from the advance proof of an article shortly to appear in the Virginia Law Review more fully referred to in the brief. Nor does the decision conform to the accepted views of the American Bar or of the business community in general.

III

The statute relative to the petitioner's lawful right to declare dividends erroneously construed by the Court of Appeals is not peculiar to the State of Virginia. Statutes in substantially the same language, affording the directors of a corporation power to declare and pay dividends to its stockholders "out of net earnings, or out of its net assets in excess of its capital" will be found in Arkansas, Connecticut, Florida, Michigan (as construed by the Tax Court in *Senior Investment Corporation, supra*), Nevada, Oregon and Tennessee. These statutes will be identified and more fully referred to in the attached brief in support of this petition. The same question under the 1942 Amendment to I. R. C., §26(c), may therefore well arise in these same states other than Virginia, with resulting conflicts to come that should impel the decision of this important Federal question by this Honorable Court.

IV

The decision of the Court of Appeals would appear to be in conflict with applicable decisions of this Court, for which we may at this point refer to *Mobile & Ohio Railroad* v. *Tennessee* (1894), 153 U. S. 486, which, although relied upon by the Court of Appeals (Rec. p. 23), states at page 496:

> "Again, dividends can be rightfully paid only out of profits. *Corporations are liable to be enjoined by shareholders or creditors from making a distribution, in dividends, of capital.* Taylor on Corporations, section 565, and authorities cited." (Italics ours.)

So in *Van Norman Co.* v. *Welch, supra,* the First Circuit, in 1944 (141 Fed. [2d] 99), in deciding a case arising under the Undistributed Profits Tax Act, relied upon another decision of this Court, saying at page 101:

> "'An impairment of fixed or statutory capital occasioned by a deficit must be restored out of subsequent earnings before there can be accumulated earnings or profits available for dividends. The same rule governs impairments of capital surplus or paid-in surplus.' Mertens Law of Federal Income Taxation, § 9.30; Willcuts v. Milton Dairy Co., 1927, 275 U. S. 215, 48 S. Ct. 71, 72 L. Ed. 247."

Willcuts v. *Milton Dairy Co.* was decided by this Court in 1927.

Petitioner respectfully submits that the prohibition against the declaration of dividends by a corporation in the face of a profit and loss deficit and consequent capital impairment is the law of this Court, as it is a fundamental concept of American corporation law, unless *explicitly* permitted by the local statute. Statutes of that type are in derogation of the common law, and examples will now be found in California, Delaware, Georgia, Kansas, Minnesota, Montana, Nebraska and Oklahoma. These statutes

will be identified and more fully referred to in the attached brief. In each instance their language is very explicit, and in no case may the abrogation of the common law rule be left to the type of erroneous inference indulged in by the Court of Appeals in the face of all the authorities to the contrary.

V

The Court of Appeals has disregarded applicable decisions of this Court, of its sister Circuits, of the Supreme Court of Appeals of Virginia, and of all the texts on the point. The Court of Appeals has relied upon authorities that have no relation to the question before it, *or that did in fact support the contentions of petitioner.* It has bodily incorporated reference to these very cases and text writers that were cited without comment by the Government's brief, in its own opinion without analysis or comment of its own, as will all be more fully established in the appended brief. The Court of Appeals has therefore so far departed from the accepted and usual course of judicial proceeding as to call for an exercise of this Court's power of supervision.

In Summary

The only premise upon which the Court of Appeals reversed the decision of the District Court was that the use in the disjunctive of the words "net earnings" followed by the words "or out of its net assets in excess of its capital" in the Virginia statute, would validate the payment of dividend in the face of the petitioner's conceded substantial capital impairment.

In so deciding the Court of Appeals has completely disregarded not only all prevailing authority, but also the *rationale* of the numerous statutes containing the same language. It is recognized that corporations who may have one or more unsuccessful years may nevertheless with en-

tire validity, and often do, dip into "net assets in excess of capital", e.g., surplus previously accumulated (presupposing that such a surplus exists) to maintain their dividends to stockholders. Such is the only purpose of the disjunctive language in the Virginia and six other kindred State statutes now prevailing. That language should not have been contorted to overcome the general prohibition implicit in established corporation law against the payment of a dividend in the face of a conceded capital impairment (failing explicit statutory sanction of the detailed type now prevailing in Delaware and some seven other States), and no such interpretation may be lightly read into the Virginia statute.

The last paragraph of that statute (supra, p. 4) *imposes sanctions upon the directors for paying dividends "out of any part of the capital". No exception appears regarding "current" or "annual"* earnings. The taxpayer's earnings for 1937 were far less than its capital impairment. Hence any dividend in 1937 would perforce have come out of some "part of the capital", which the statute effectively prohibits (see *International Ticket Scale Corporation* v. *United States, supra,* p. 7, and *infra,* p. 15).

CONCLUSION

For the reasons stated in this petition and the annexed brief as well as the general public interest to the business community and to the Bench and bar, this petition for a writ of certiorari to the Court of Appeals for the Fourth Circuit should be granted.

Dated, November 8, 1948.

Respectfully submitted,

EUGENE UNTERMYER,
ROBERT T. BARTON, JR.,
Attorneys for Petitioners.

IN THE

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OCTOBER TERM, 1948

No.

HENRY C. RIELY and ROBERT T. BARTON, JR., as Receivers of PIERCE OIL CORPORATION, a Virginia Corporation, heretofore dissolved,

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vs.

UNITED STATES OF AMERICA,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

POINT I

The Conflicts Below.

Glenn v. *Mengel Co.* (1944), 145 Fed. (2d) 235, in the Sixth Circuit, affirming *Mengel Co.* v. *Glenn* (D. C. W. D. Ky., 1943), 50 Fed. Supp. 765, involved the Federal Undistributed Profits Tax, wherein the Court was required to construe the New Jersey statute precluding payment of a corporate dividend except "from its surplus * * * or from the net profits arising from the business of the corporation." The District Court, whose decision for the taxpayer was affirmed in the Sixth Circuit, said at page 769:

> "The New Jersey statute above referred to permits dividends to be paid out of 'net profits.' *It does not authorize a payment out of net income for any particular year.* During the year 1936 the plaintiff had an impairment of capital, *since its surplus accounts under usual corporate accounting is properly treated as part of its permanent capital.* Edwards v. Douglas, 269 U. S. 204, 214, 46 S. Ct. 85, 70 L. Ed. 235; Willcuts v. Milton Dairy Co., 275 U. S. 215, 218, 48 S. Ct. 71, 72 L. Ed. 247; Peaks v. Thomas, 222 Ky. 405, 407, 300 S. W. 885." (Italics ours.)

In searching for a distinction, the opinion of the Circuit Court of Appeals for the Fourth Circuit (herein sometimes called the Court of Appeals) referred to the fact that the Court in *Mengel* v. *Glenn* (Rec. p. 25):

> "stressed the difference between the term 'net profits' (used in the Statute) and 'net income for any particular year' ",

but there is nothing in the ordinary canons of construction that may lightly interpret the Virginia statute in the face of a capital impairment to permit payment of dividends from "net earnings" any more than from net profits, "for any particular year." That construction can be spelled out only from the Delaware type of statute. (See "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws", by Messrs. Henry W. Ballantine and George S. Hills [1935], 23 California Law Review 229, at pp. 241, 242, more fully referred to *infra* at Point III, but nevertheless cited in the opinion to support the decision below.)

The Court of Appeals, by its opinion herein, concedes that the Tax Court decision of *Senior Investment Co.*, 2 T. C. 124, in a case arising under the Undistributed Profits Tax Law, conflicts with its views, but we respectfully submit that the Court was not justified in stating that the Michigan statute therein construed differed in any respect

from the Virginia statute before them (Rec. p. 25). Both statutes permitted dividends *in the disjunctive* from "net earnings" or (in Michigan) from "earned surplus" and (in Virginia) from "net assets in excess of its capital." The Michigan statute even used the word "either", which does not appear in the Virginia statute.

In discussing *International Ticket Scale Corp.* v. *U. S.* (1948), in the Second Circuit, 165 Fed. (2d) 358, the Court of Appeals quite properly referred to the *Delaware* statute therein considered as "expressly" permitting dividends from net earnings when there was a capital deficit. The Court of Appeals, however, proceeds to state (Rec. p. 25) that:

> "the New York Statute imposed liability on the officers, directors and stockholders for such a practice."

Precisely the same sanctions are however contained in the Virginia statute (see Petition herein, pp. 4, 12).

In *United States* v. *Byron Sash & Door Co.* (C. C. A. 6th, 1945), 150 Fed. (2d) 44, and *Van Norman Co.* v. *Welch* (C. C. A. 1st, 1944), 141 Fed. (2d) 99, both Courts assume without discussion that dividends are inadmissible in the face of a capital impairment, the opinion in the case last named citing *Willcuts* v. *Milton Dairy Co.* (1927), 275 U. S. 215, as authority.

All four of these cases in the Circuit Courts of Appeals in three different Circuits involved the Federal Undistributed Profits Tax.

The tenor of the foregoing decisions emphasizes the accepted prohibition against payment of dividends in the face of a capital impairment. This doctrine has been the uniformly accepted concept of corporation law until the decision of the Court of Appeals herein. Its application to the Federal question arising under the Internal Revenue Code herein should furnish ample occasion for granting the petition to this Honorable Court, on the ground of conflict alone.

POINT II

The Court of Appeals has decided this important question of the local law of Virginia probably in conflict with applicable local decisions.

The opinion (Rec. p. 24) cited without discussion *Drewry-Hughes Co.* v. *Throckmorton* (1917), 120 Va. 859, a decision by the Supreme Court of Appeals of Virginia. The question therein presented had no relation to the right of directors to declare current dividends in the face of a capital impairment, since that case was concerned only with the rights *inter sese* of preferred and common stockholders with respect to unpaid cumulative dividends on the dissolution and consequent liquidation of the company.

The Court of Appeals has not, however, seen fit to refer to a distinct expression by the Supreme Court of Appeals of Virginia conflicting with its decision, that appears in *Johnson* v. *Johnson & Briggs,* decided March 20, 1924, rehearing denied April 9, 1924, 138 Va. 487, also appearing at 122 Southeastern Reporter, page 100. That case involved the same question considered in *Drewry-Hughes Co.* v. *Throckmorton, supra,* and the Supreme Court of Appeals of Virginia said at page 102:

> "The contrary view unduly emphasizes *the conceded fact* that it is fundamental that capital cannot be impaired by the declaration of dividends out of the capital assets of the corporation * * *." (Italics ours.)

From the foregoing expression of opinion by the highest Court of Virginia it would appear that dividends cannot be declared out of capital or in the face of a capital impairment under Virginia law any more than under the law of any other State, failing an explicit enabling statute of the Delaware type.

Counsel have been favored with an advance proof of an article appearing in Volume 34 of the Virginia Law Re-

view, No. 7, commenting upon the Court of Appeals' decision herein, which among other matters will read as follows:

> "While a literal reading of the disputed clause with its ambiguous term 'net earnings' will support the construction which the court adopted, the decision seems incorrect when the statute is read in its entirety. This becomes apparent when the second paragraph of Virginia Code Annotated, Section 3840, 1942, providing for penalties if dividends are declared out of capital, is considered. Not only is this interpretation contrary to the usual rule restricting the source available for dividends, *but it is also contrary to the general understanding of Virginia attorneys as to the meaning of the statute. The decision is unfortunate in that it permits what is usually considered an unsound financial policy.* Stevens' Handbook on Corporations, Section 100, 1936." (Italics ours.)

POINT III

The Court of Appeals has decided an important question of Federal law which has not been but should be settled by this Court.

The general importance of the question involved would appear manifest from the other points we are submitting herein. We further submit that the determination of the Court of Appeals is at variance with the purpose and intent of the 1942 amendment (Sec. 501[a][2] of the Revenue Act of 1942, amending Sec. 26 of the Internal Revenue Code), which was enacted for the relief of taxpayers, as appears from this Court's decision in *U. S.* v. *Ogilvie Hardware Co.* (1917), 330 U. S. 709, at pp. 713, 717.

In addition to the foregoing considerations, there are a sufficient number of other States where the statute is practically identical with the Virginia law to warrant a final resolution by this Court of this unsettled question that may arise under the 1942 Amendment.

Arkansas General Corporation Act, Chapter 37, paragraph 2183:

> "Dividends may be paid to stockholders from the corporation's net earnings or from the surplus of its assets over liabilities, including capital, but not otherwise."

Connecticut General Corporation Law, Section 3386:

> "No corporation shall pay any dividend or make any other distribution of its assets except from its net profits or actual surplus."

Florida General Corporation Law, Section 612.23:

> "Dividends may be paid to stockholders from a corporation's net earnings, or from the surplus of its assets over its liabilities, including capital, but not otherwise."

The *Michigan* statute, General Corporation Act, Section 22, that was construed favorably to this petitioner in *Senior Investment Corporation,* 2 T. C. 124, afforded directors power to declare and pay dividends "*either* from earned surplus or from net earnings", but the statute has since been amended to omit the words "or from net earnings".

Nevada General Corporation Law, Section 1625:

> "Dividends may be paid to stockholders from a corporation's net earnings or from the surplus of its assets over its liabilities, including capital."

New Jersey General Corporation Act, Section 14:8-19 precludes payment of dividends except from "surplus • • • or net profits" as construed in *Glenn* v. *Mengel Co., supra.*

Oregon Corporations and Associations Code, Section 77-221 precludes the payment of dividends among other matters "out of assets other than net profits or surplus".

Tennessee General Corporation Law, Section 2727:

> "Dividends may be paid to stockholders from the corporation's net earnings or from the surplus of its net assets over its liabilities, including capital, but not otherwise."

Each of the foregoing laws, as in Virginia, imposes sanctions on the directors and sometimes on the stockholders for violation, by making them personally liable jointly and severally for paying dividends except as so permitted, sanctions that were held in *International Ticket Scale Corporation* v. *United States, supra,* to be an effective "prohibition" within the meaning of the 1942 Amendment to the Revenue Act of 1936.

The authors of the article in the California Law Review, *supra,* have also listed Rhode Island and Indiana as within the foregoing categories, but we have purposely omitted them because each of these laws also contains an additional prohibition against impairment of capital. The article in question in reference to the statutes in this language states, however, at 23 California Law Review, page 242:

> "In most, if not all, of the statutes in which the terms 'net profits' or 'earnings' are employed without specifying some particular period for their determination, *it thus appears that no alternatives to surplus are intended.*" (Italics ours.);

in the face of the Court of Appeals' opinion invoking the same as authority for its conclusion herein.

The Commissioners' Note to Uniform Laws Annotated, Business Corporations Act, Section 24, dealing with dividends, states:

> "Nearly every statute contains a provision prohibiting the payment of dividends out of capital, *or the converse statement permitting the payment of dividends only out of surplus or profits.* (Mechen, Sec. 1313.)" (Italics ours.)

POINT IV

The question herein involving the Internal Revenue Code has been decided by the Court of Appeals in a way probably in conflict with the applicable decisions of this Court.

This Court has expressed the view, in no uncertain language, that a dividend is unlawful in the face of a capital deficit, in *Mobile & Ohio Railroad Company* v. *Tennessee* (1894), 152 U. S. 486, 496, from which we have quoted at page 10 of our petition.

A Federal case to the same effect is *Main* v. *Mills* (C. C. W. D., Wisc., 1874), 16 Fed Cases 506, where the Court said at page 507:

> "The officers of such a corporation have no right to make dividends to stockholders unless there are profits to be divided, over and above all losses, because the necessary result of so doing is to deplete the capital fund."

Although this cause involves the interpretation of a Virginia statute, we respectfully submit that the actual question is a much broader one. Occurrence of numerous statutes in the same language to which we have referred in the previous point and the willingness of the Court of Appeals lightly to construe the Virginia statute to be in derogation of the common law (the local law and all other authorities to the contrary notwithstanding), has already and will probably prove of increasing concern to bench and bar as well as to directors of many corporations.

So that the Court may be apprised of those instances where the Legislature has spelled out the intent to permit dividends from current earnings in the face of a capital impairment, we venture to refer in some detail to all of the statutes, now eight in number, that are drawn in language appropriate for that purpose.

They all are drawn in very explicit language and contain numerous safeguards. The earliest enactment of this type appears in *Delaware* General Corporation Law, Section 34, passed in 1927, of which the relevant part reads as follows:

> "The directors of every corporation created under this Chapter, subject to any restrictions contained in its Certificate of Incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14, 26, 27 and 28 of this Chapter, or (b) *in case there shall be no such excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year;* • • •." (Italics ours.)

The same section proceeds in careful verbiage to require the capital, computed as aforesaid, if diminished for a number of explicit reasons, to be preserved intact for so much thereof as is represented by the issued and outstanding stock of all classes having preference upon the distribution of assets, and precluding payment of dividends in any event if that part of the capital should become impaired, with additional explicit provision regarding so-called "wasting asset" corporations.

The Corporations Code of *California,* Division 1, General Corporation Law, Chapter 3, "Dividends", provides in Section 1500:

> "A stock corporation may declare dividends payable in cash or in property only as specified in one of the following subdivisions:
>
> (a) Out of earned surplus.
>
> (b) Out of net profits earned *during the preceding accounting period,* which shall not be less than six months nor more than one year in duration. The corporation may declare dividends out of such net profits *despite the fact that the net assets of the corporation*

amount to less than the stated capital; * * *." (Italics ours.),

followed by the same type of prohibition as the Delaware statute if the net assets amount to less than the aggregate amount of stated capital attributable to shares having liquidation preferences.

Georgia, General Corporation Law, Section 22-1835 provides:

> "DIVIDENDS ON STOCK REGULATED.—Subject to any restriction in the charter, a corporation may by resolution of its board of directors declare and pay dividends in cash or property out of its net assets in excess of its capital stock, according to its charter or amendments thereof, or, *in case there shall be no such excess,* out of its net profits *for the fiscal year then current* and/or *the preceding fiscal year:* * * *." (Italics ours.),

followed by the same prohibition if the capital attributable to stock having liquidation preferences is impaired, as in Delaware and California, and by provisions in relation to distribution by "wasting asset" corporations if the charter so provides.

Kansas, General Corporation Code, Article 35—DIVIDENDS, provides by Section 17-3501:

> "DIVIDENDS, BY WHOM DECLARED, PAYABLE OUT OF WHAT FUND. Subject to any restrictions in its articles of incorporation and the provisions of this act, the directors of every domestic corporation shall have the power to declare and pay dividends upon the shares of its capital stock either out of
>
> *A.* Net assets in excess of its capital as computed in accordance with the provisions of sections 43, 54, 57, 58, 126, 127, 128, 129, and 130 of this act, or
>
> *B. Net profits for the fiscal year then current or the preceding fiscal years in case there shall be no such excess as mentioned in A above."* (Italics ours.)

Minnesota, Business Corporation Act, Section 301.22, defines in great detail the fair value of the corporation's assets in subdivision 1, and then proceeds:

> "Subdivision 2. Dividends in cash or property. A corporation may declare dividends in cash or property only as follows:
>
> (1) Out of earned surplus;
>
> (2) Out of paid-in surplus; * * *"

(if there are preferred stockholders then to them only, and in any event upon concurrent notice to the recipients of the dividend);

> "(3) *Out of its net earnings for its current or for the preceding fiscal year, whether or not it then has a paid-in or earned surplus*: * * *." (Italics ours.),

with the same prohibition where the capital attributable to classes of stock having liquidation privileges becomes impaired, as is contained in the several statutes above referred to.

Montana, General Corporation Law, Section 5939, provides:

> "[DIVIDENDS TO BE MADE FROM SURPLUS PROFITS ONLY].—The directors or trustees of every corporation shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of the aggregate amount of capital represented by the issued and outstanding stock having a par value and the amount of capital represented by shares without nominal or par value, if any, or (b), *in case there shall be no such excess, out of its net profits for the fiscal year then current or for the preceding fiscal year or both;* * * *." (Italics ours.),

followed by the same prohibition in case of impairment of stock having liquidation privileges, as appears in the statutes previously cited, and by additional explicit provisions relative to payment of dividends from wasting assets or from reserves set aside.

Nebraska, General Corporation Law, Section 21-175, provides:

> "DIVIDENDS; FUNDS AVAILABLE FOR.—The directors of every corporation operating or organized under this act, subject to any restrictions contained in its articles of incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (1) out of its net assets in excess of its capital as computed in accordance with the provisions of sections 21-129, 21-130, 21-151, 21-153, 21-154 and 21-161, or (2) *in case there shall be no such excess, out of its net profits for the fiscal year then current or the current and preceding fiscal year;*" (Italics ours.),

followed by a similar prohibition if the capital is reduced to an amount less than that represented by shares having a preference upon the distribution of assets.

Oklahoma, General Corporation Act, Section 132, is even more detailed and limits directors in declaring or paying dividends only as follows:

> "(1) Out of earned surplus;
>
> (2) Out of paid-in surplus upon shares entitled to preferential dividends or liquidation preferences; or
>
> (3) *While any impairment of the stated capital exists,* out of the net profits to the extent of an aggregate amount *not exceeding one-half* (½) *of such net profits earned during the preceding accounting period,* which shall be not less than six (6) months nor more than one (1) year in duration; provided, that, if there shall be outstanding shares entitled to preferential dividends or liquidation preferences, dividends out of net profits shall thus be payable only upon shares entitled to preferential dividends. In no case shall such dividends be paid unless the value of the net assets of the corporation remaining after the payment thereof shall be at least equal to the sum of the highest aggregate amount of liquidation preference of all shares then outstanding having a liquidation preference, if any, plus an amount equal to one-half (½) of

> the remainder resulting from subtracting such aggregate amount of liquidation preferences from the amount of stated capital of the corporation." (Italics ours.)

This is followed by reference to distributions from wasting assets, and subsection (c) requires notice to be given to the shareholders whenever the dividend is paid from a source other than earned surplus.

Now it seems perfectly manifest that where the State legislature has intended to permit modification of the common law rule, then very explicit and detailed language is used to validate payments of dividends in the face of a capital impairment.

We have sought to research what we believe to be the most recent corporation statutes on the subject in all the forty-eight States, the District of Columbia and Hawaii, and the eight examples given above were the only ones disclosed where the so-called Delaware type of statute has been enacted. In each instance the extent of detail and limitations provided by the legislature reflect the precautions deemed appropriate in permitting departure from the general rule of corporation law prohibiting payment of dividends when there is a profit and loss deficit or the capital of the corporation is impaired.

To complete the record we may add that the statutes of twenty-five other States and Districts, not previously listed, may generally be classified as permitting payment of dividends, in some cases from "surplus profits", in other cases from "net assets in excess of capital", and in still other instances by applying both criteria, and that the remaining statutes, some six in number, either limit the prohibition to cases where the corporation is insolvent or where the dividend would render it insolvent, or have other special provisions equally not germane to the present issue.

POINT V

The Court of Appeals has so far departed from a fundamental rule of law and from the accepted and usual course of judicial proceedings by disregarding all controlling decisions and authorities and by relying without analysis or comment upon authorities that in fact support petitioner's contentions, as to call for an exercise of this Court's power of supervision.

The opinion of the Court of Appeals relies, among other cases, upon *Mobile & Ohio Railroad Company* v. *Tennessee, supra,* notwithstanding that the only statement in that opinion (from which we have quoted in our petition) which bears upon the question herein would appear directly to controvert that Court's determination.

So remaining cases in this Court from which the Court of Appeals quotes or refers to in its opinion (Rec. pp. 23, 24) have no relation whatever to the question of the legality or illegality of the declaration or payment of dividends in the face of a capital impairment.

The actual trend of the Virginia decisions as in direct variance with the Court of Appeals' decision, has been set forth in Point II hereof.

The only possible support for the views of the Court of Appeals (again of course in the absence of the Delaware type of statute) can be found alone in the British rule, which is discussed with considerable detail in an article entitled "Theory of Anglo-American Dividend Law—The English Cases", by Joseph L. Weiner, 28 Columbia Law Review, page 1046. In a subsequent article in 29 Columbia Law Review, entitled "Theory of Anglo-American Dividend Law—American Statutes and Cases", the same author commences by stating at page 461:

> "The English dividend theory, outlined in a prior paper, has *hitherto* been *wholly foreign* to American thought and decision. In America the fundamental

> principle of courts and legislatures has been to *preserve among the corporate assets some equivalent for the original contribution received by the corporation in exchange for its shares of stock.*" (Italics ours.)

The word "hitherto" is explained in still a later article by the same author (29 Columbia Law Review, 906), where the following significant statement appears at page 909:

> "Permitting dividends to be paid out of current profits irrespective of past losses *is a novelty* introduced into America by the 1927 amendment to Section 34 of the Delaware General Corporation Law." (Italics ours.)

and continues on the same page:

> "The only analogy to this current profit test of the legality of a dividend is the English law. According to the English cases dividends may as a rule be paid out of current profits without first making good past losses."

The Court of Appeals has nevertheless (Rec. p. 24) cited not only Mr. Weiner's article but also the Ballantine-Hills article in the California Law Review (*supra*, Points I and III of this brief) as ostensibly in support of its determination.

Nothing contained in the remaining citations relied upon in the opinion lends any more support to the conclusions reached by the Court of Appeals than do those to which we have previously referred.

The Government's brief in the Court below did not see fit to quote from most of the authorities upon which it relied, and the only reasonable conclusion that may be inferred is that the Court of Appeals bodily incorporated the citations contained in the Government's brief (as it did), without embarking upon any analysis of its own.

The Court of Appeals manifestly erred in so lightly construing the Virginia statute to be in contradiction to the established rule of American Corporation Law.

Leading text writers assume without discussion that capital cannot be impaired by payment of dividends. Thus, among the older authorities, *Morawetz on Private Corporations* (2d Ed.), Vol. 1 (p. 410), at Section 435, entitled "Dividends may be paid out of Profits" proceeds to state:

> "It is a fundamental rule, that dividends can be paid only out of profits or the net increase of the capital of a corporation, and cannot be drawn upon the capital contributed by the shareholders for the purpose of carrying on the company's business. • • • The managing agents, and even the holders of a majority of shares, have no authority to diminish the prescribed capital of the company by distributing a portion of it among the shareholders in the shape of dividends."

Thompson on Corporations (2d Ed.), Vol. 5 (1910), states at page 109:

> "§ 5305. Dividends must be declared from profits.—Ordinarily dividends can be declared and paid only out of the profits or surplus earnings of the corporation. *The rule of law that requires corporations to preserve their capital intact* is alone sufficient to prevent the corporation from paying dividends except out of profits." (Italics ours.)

This rule is reiterated as follows in *White's Supplement* (1915), cited as 8 *Thompson on Corporations,* at page 564:

> "§ 5305. Dividends must be declared from profits.—Corporate dividends are to be paid from the surplus profits after they have been earned, but not from the capital."

The identical language appears in the 1922 Cumulative Supplement to Thompson's work in Section 5305 at page 889, citing among other cases *Drewry-Hughes Co.* v. *Throckmorton,* 120 Va. 859, *in support* of such proposition.

Cook on Corporations (8th Ed.), Vol. II, states at page 1911:

> "§ 547. A stockholder may enjoin an illegal dividend.—A court of equity will, upon the application of a stockholder, enjoin an attempt to distribute in dividends any part of the capital stock."

A text as recent as *Fletcher's Cyclopedia of the Law of Private Corporations* (1932), states in Volume II at page 821:

> "It is a settled rule, therefore, even in the absence of any statutory provision, that a corporation cannot lawfully declare dividends out of its capital stock, and thereby reduce the same, or out of assets which are needed to pay the corporate debts.",

citing as authority *Mobile & Ohio Railroad Co.* v. *Tennessee, supra,* in this Court, and *Drewry-Hughes Co.* v. *Throckmorton, supra,* in the Supreme Court of Appeals of Virginia. The author proceeds (p. 838):

> "Sec. 5335. Determination of surplus or net profits, available for dividends—What constitutes 'surplus,' 'net profits,' 'income,' etc.
>
> It is clear that there cannot be surplus or net profits for the purpose of declaring a dividend, unless the total value of the assets of the corporation at the time it is proposed to declare the dividend exceeds the amount of its capital stock, after deducting all expenses which have been incurred, and all losses which have been sustained."

Even in States such as Delaware, the Courts recognize the general rule of law, as appears from *Sapperstein* v. *Wilson & Co.* (1935), 182 Atl. 18, decided some eight years after the passage of the explicit Delaware statute on the subject, where the Chancellor said at page 20:

> "It is a general rule of law, in the absence of statutory provision *to the contrary,* that the capital of a corporation shall not be impaired by the paying out of dividends to stockholders." (Italics ours.)

We therefore respectfully urge that the Court of Appeals has sedulously disregarded every Federal and Virginia case, as well as the authority of all the text-writers on the subject, and has proceeded to rely upon one case in this Court and another in the highest Court of Virginia, and upon at least two Law Review Articles, *all of which are actually to the opposite effect,* in arriving at its determination of this question.

CONCLUSION

There is nothing in the history or genesis of the Virginia statute that can lead to the conclusion of any intent to modify the general rule. Doubtless the Virginia legislature sought to make assurance doubly sure that dividends might be declared from a surplus previously accumulated, in one or more years when there were no annual net earnings, but nothing contained in the statute can lead to upsetting the generally accepted concept that the capital must be maintained intact, and if impaired then replenished in full before a dividend may lawfully be declared or paid.

The general American rule is clear and requires no further exposition. The Circuit Court of Appeals for the Fourth Circuit has nevertheless construed the Virginia statute as if it were the Delaware type of statute in deciding an important question of law and one of general concern, that we respectfully submit impels final and responsible elucidation.

The petition for certiorari should be granted.

Respectfully submitted,

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Dated, November 8, 1948.